

**TAX COMPLEXITY AND THE CAPITAL-REVENUE
DISTINCTION – LESSONS TO BE LEARNT FROM TWO
RECENT NEW ZEALAND CASES**

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ABSTRACT

Income taxation is complex. Complexity arises due to the nature of the subject matter as well as through the expression (drafting) of tax laws. In an attempt to address the second issue the New Zealand Income Tax Act has been reorganised and is currently being rewritten in an endeavour to simplify it. Tax complexity arising from the nature of the subject matter is potentially more difficult to address. One of the areas causing complexity in this context is the capital-revenue distinction.

Against this background this paper examines recent judicial trends in New Zealand as evident in two 2006 cases to ascertain what guidance they provide in this complex area. The first, a decision of the New Zealand Court of Appeal, concerned the tax treatment of legal expenses incurred by the taxpayer in unsuccessfully seeking compensation arising from alleged unlawful acts or omissions in the course of a tender process the taxpayer was involved in (*Fullers Bay of Islands Ltd v CIR*). The overall approach of the New Zealand High Court in this case is also very instructive. At issue in the second case, *TRA Case W26*, was whether expenditure incurred in earthquake strengthening a building was deductible. These cases provide guidance on a number of issues including the continuing use of the fixed and circulating capital test; the use of the accounting treatment adopted; the impact regulatory requirements have on deductibility and the manner in which work is undertaken (including the issue of deferred maintenance).

Tax complexity and the capital-revenue distinction – lessons to be learnt from two recent New Zealand cases

1 INTRODUCTION

Income taxation is “inherently ... complex”.¹ According to Prebble the concept of income is: “in some senses an artificial construct, to the extent that it may also be a fiction.”² Complexity arises due to the nature of the subject matter as well as through the expression (drafting) of tax laws. In an attempt to address the second issue the New Zealand Income Tax Act has been reorganised and is currently in the final process of being rewritten in an endeavour to simplify it. In November 2006, the Government introduced the Income Tax Bill 2006 (the Bill). When enacted, it will complete the rewrite of New Zealand’s income tax law. The Bill re-enacts and consolidates amendments to Parts A to E and also rewrites Parts F to O. The Bill also introduces a small number of intended changes to the legislation. Once enacted the new Act will apply to income derived from the 2008-09 tax year.³

Tax complexity arising from the nature of the subject matter is potentially more difficult to address. One of the areas that causes complexity in this context is the capital-revenue distinction. Trombitas comments that this distinction is “one of the most difficult areas of income tax law. It is tempting to say it is the hardest area of tax law.”⁴ Case law is testament to how difficult making this distinction can be. Certain judges writing in this area display overtly a sense of judicial depression, possibly never better expressed than by Lord Greene in *IRC v British Salmson Aero Engineers Limited*.⁵

¹ J Prebble, “100 Years of Income Tax” (1993) Vol 47 *Bulletin for International Fiscal Documentation* 59, at 60.

² J Prebble, “Can Income Tax Law Be Simplified?” (1996) Vol 2:4 *New Zealand Journal of Taxation Law and Policy* 187, at 190. See also J Prebble, “Fictions of Income Tax” (2002) *Australasian Tax Teachers Association Conference*, Manukau (January) and W Chan, “Income – A Subjective Concept” (2001) Vol 7:1 *New Zealand Journal of Taxation Law and Policy* 25. For a comprehensive discussion of the concept of income see K Holmes, *The Concept of Income - A multi-disciplinary analysis* (The Netherlands, IBFD Publications BV, 2001).

³ For further information see <http://www.taxpolicy.ird.govt.nz/>. For details of the overall reorganisation and rewrite see AJ Sawyer, “Rewriting the NZ Income Tax Act 1995 – the Income Tax ‘Act’ 2003” (2003) Vol 9:1 *New Zealand Journal of Taxation Law and Policy* 12; Inland Revenue Department (IRD), “Income Tax Act” (2004) Vol 16:5 *Tax Information Bulletin* 46; D McLay and C Macalister “Income Tax Act 2004 – The Scoreboard to Date” (2005) *New Zealand Institute of Chartered Accountants 2005 National Tax Conference* (October) and AJ Sawyer, “New Zealand’s Tax Rewrite Program – In Pursuit of the (Elusive) Goal of Simplicity” (2007) *Australasian Tax Teachers’ Association Conference*, Brisbane (January).

⁴ E Trombitas, “The New Zealand Judiciary and the Capital/Revenue Distinction – Laying the Essential Foundations.” (2006) In Adrian J Sawyer (Ed.) *Taxation Issues in the Twenty-First Century* (Christchurch: The Centre for Commercial and Corporate Law Inc.) 51.

⁵ *IRC v British Salmson Aero Engineers Limited* [1938] 2 KB 482, at 492.

“...in many cases it is almost true to say that the spin of a coin would decide the matter [as to capital or revenue] almost as satisfactorily as an attempt to find reasons.”

Others have described the distinction as “an intellectual minefield in which the principles are elusive and analogies treacherous”: *Tucker v Granada Motorway Services Ltd*.⁶

Against this background this paper examines two recent New Zealand cases to see what guidance they provide in this complex area. The first, a decision of the New Zealand Court of Appeal (the Court of Appeal), concerned the tax treatment of legal expenses incurred by the taxpayer in unsuccessfully seeking compensation arising from alleged unlawful acts or omissions in the course of a tender process the taxpayer was involved in (*Fullers Bay of Islands Ltd v CIR*).⁷ The overall approach of the New Zealand High Court (the High Court) in this case is particularly instructive. At issue in the second case, *Case W26*, heard before the Taxation Review Authority (TRA), was whether expenditure incurred in earthquake strengthening a building was deductible.

The remainder of the paper is set out as follows. Section 2 of this paper briefly outlines the legislative setting for the capital-revenue distinction in New Zealand. The two cases are analysed in sections 3 and 4 of this paper, respectively. Concluding comments and observations are made in section 5.

2 THE LEGISLATIVE SCHEME

Section DA 1(1) of the Income Tax Act 2004 (“ITA 2004”), called the ‘general permission’, provides that:

“A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is –

(a) incurred by them in deriving –

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving –

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.”

⁶ *Tucker v Granada Motorway Services Ltd* [1977] 3 All ER 865, at 869 (per Templeman J) (*Tucker*).

⁷ (2006) 22 NZTC 19,716 (*Fullers* (CA)).

The ITA 2004 applies from the beginning of the 2005-2006 income year.⁸ The equivalent provision in the Income Tax Act 1994 (“ITA 1994”) is contained in s BD 2(1) of that Act.⁹

Section DA 1 ITA 2004 is subject to the general limitations in s DA 2 of that Act, including the capital limitation (subsection (1)), which denies a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. The equivalent capital prohibition in the ITA 1994 is contained in s BD 2(2)(e) of that Act.

The intention of the drafting of the ITA 2004 was to ensure that, except in respect of a limited number of intended policy changes, no change to the pre-existing law was made.¹⁰ The general deduction provisions have been rewritten and reorganised as Part D of the ITA 2004. However, there has been no change in their application and therefore the discussion of cases and IRD comments concerning the ITA 1994 (and equivalent sections in earlier tax Acts) in this paper apply equally to the ITA 2004.

The capital-revenue distinction is also important in New Zealand in part because New Zealand does not have a comprehensive capital gains tax.¹¹ The term “income” is not defined exhaustively in New Zealand tax legislation, rather a number of specific provisions (in Part C of the ITA 2004) outline what is included in the term for income tax purposes. In addition, there is a “catch-all” provision, s CA 1(2) ITA 2004¹² which provides that: “An amount is also income of a person if it is their income under ordinary concepts.”

The term “capital” is not defined in either the ITA 2004 or ITA 1994. However, there is a considerable body of case law on the application of the ITA 1994 provision and equivalent provisions in the earlier Income Tax Acts. In New Zealand the “governing approach is exemplified in the observations of Lord Pearce”¹³ in *BP Australia Limited v FCT*¹⁴ (*BP Australia*) including:¹⁵

⁸ In May 2004 the New Zealand Parliament passed the ITA 2004 which represented the third stage in the rewrite of income tax legislation, using plain language techniques.

⁹ Section BD 2(1) of the ITA 1994 similarly provides an amount is an allowable deduction to the extent that it is an expenditure or loss incurred by the taxpayer in deriving their gross income or necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving their gross income.

¹⁰ All intended policy changes are listed in Schedule 22A of the ITA 2004. The Government established Rewrite Advisory Panel has been given the role of considering whether any unintended legislative changes arise under the ITA 2004 and to make recommendations as to how any such changes should be dealt with. For further information see IRD, “Rewrite Advisory Panel” (2004) Vol 16:6 *Tax Information Bulletin* 35 and the Rewrite Advisory Panel website <http://www.rewriteadvisory.govt.nz>.

¹¹ While New Zealand does not have a comprehensive capital gains tax regime, the ITA 2004 (and ITA 1994) treats certain types of gains as being within the term “income” even though generally they would be considered capital gains. Such taxable gains include (i) certain profits or gains from the sale of land (ss CB 5 – 21 ITA 2004; s CD 1 ITA 1994) and (ii) amounts from personal property (ss CB 2 – CB 4 ITA 2004; s CD 4 ITA 1994). For a discussion of the taxation of receipts and the capital-revenue boundary see D Dunbar, “The Taxation of Inducement Payments” (2000) Vol 6:2 *The New Zealand Journal of Taxation Law and Policy* 115.

¹² Previously s CD 5 ITA 1994.

¹³ *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9,101, at 9,103 (*Thomas Borthwick*). See also *CIR v LD Nathan & Co Limited* [1972] NZLR 209; *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271; *CIR v McKenzies New Zealand Limited* (1988) 10 NZTC 5,233 (*McKenzies*); *Christchurch Press Company Limited v CIR* (1993) 15 NZTC 10,206 (*Christchurch*

“The solution to the problem [of distinguishing capital and revenue] is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer... the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:

‘depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process.’

(per Dixon, J. in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at p 648).”

The passage cited above from *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (*Hallstroms*) is hereafter referred to as the “*Hallstroms test*”.

3 CIR v FULLERS BAY OF ISLANDS LTD

3.1 The facts

The taxpayer company, Fullers Bay of Islands Ltd (Fullers) had established a number of successful tourist and passenger operations with some 15 distinct profit centres. Its maritime and coach divisions, based in the Bay of Islands, operated a range of cruises, tours and ferry services. Fullers decided to expand its existing Auckland business (which included lunch and dinner cruises around Auckland Harbour).¹⁶ Upon learning that the passenger ferry service between Devonport and Auckland City was to be offered for public tender, the taxpayer put in a tender to the Auckland Regional Council (ARC). At the time the service was run by an unrelated entity, Fullers Group Ltd (FGL) with a subsidy of \$250,000 per annum from the ARC. By using its Auckland ticketing system and one of its existing fleet of eight vessels Fullers calculated that it could run the service with a subsidy of only \$10,000 per annum and tendered accordingly. The turnover of its maritime division was \$5.4 million. This accounted for about 60% of its total operating revenue in the financial year ending 31 May 1998. It was estimated that the Devonport run would increase the turnover of the maritime division by another \$5 - \$6 million without requiring proportionate

Press); *CIR v Wattie* (1998) 18 NZTC 13,991 (*Wattie* (PC)) and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981 (*Birkdale*).

¹⁴ [1966] AC 224.

¹⁵ *Ibid*, at 265.

¹⁶ Its Auckland base comprised two offices and staff, which promoted the Bay of Islands activities. The taxpayer had in place an infrastructure and computer ticketing system that could readily accommodate growth.

expansion of its infrastructure. Fullers understood that, if successful, it would have a monopoly for the duration of the five year ferry service contract.

The tender was viewed favourably by the ARC who decided to contract with Fullers for the provision of the Devonport ferry service. However, upon the ARC disclosing to FGL the particulars of Fullers tender (and prior to final notification of the results of the tender process), FGL offered to provide a non-subsidised service (known as a Commercial Registration). Fullers were unaware of this and were not given the opportunity to make a competing unsubsidised bid. The ARC accepted FGL's tender.

The taxpayer issued proceedings against both the ARC and FGL, arguing *inter alia* that the ARC had breached contractual obligations it owed to the taxpayer which caused it to lose the ferry contract (resulting in loss of income of \$6.2 million).¹⁷ The taxpayer's allegations were dismissed in a subsequent court case.¹⁸ The taxpayer sought to deduct the legal fees paid to its solicitors of \$612,792.14 in respect of the proceedings in the 1999 income year.

3.2 The TRA

At first instance, the TRA¹⁹ concluded that the legal fees were deductible under s BD 2(1)(b) ITA 1994. The TRA saw the issue as whether Fullers was seeking to enforce a process contract or to obtain specific performance of a contract to supply ferry services. It was accepted by the TRA that, while Fullers wanted the outcome of the Court case to put it in a position where it could obtain a final contract, due to the ARC's acceptance of FGL's unsubsidised bid, it was never possible for the court to actually award Fullers specific performance of the final contract. The expenditure was therefore aimed at obtaining the benefits of the process or preliminary contract. Seeking to vindicate a right to a fair contractual process, even if successful, was not to acquire any property of an enduring nature. The finding that the expenditure was on revenue account was reinforced by the accounting treatment.

The Commissioner of Inland Revenue (CIR) appealed to the High Court.

3.3 The High Court

3.3.1 Introduction

The decision of Baragwanath J²⁰ is important as it "contains a very useful and comprehensive discussion of the capital/revenue principle".²¹ In addition, his Honour's reasoning was approved on appeal by the Court of Appeal.

¹⁷ The \$6.2 million was calculated by Fullers as the discounted value of future cash flows that Fullers would have generated from operating the Devonport Ferry service if it had been awarded the contract. Remedies sought by Fullers included a declaration that, if the ARC had properly managed the process, Fullers would have been awarded the contract, and a declaration that Fullers did hold the contract for five years from the date of the order.

¹⁸ *Fullers Cruises Northland Ltd v Auckland Regional Council & Fullers Cruises Ltd*, 4 June 1999, Paterson J, HC Auckland CP438/96.

¹⁹ *Case W42* (2004) 21 NZTC 11,387. The TRA is a judicial authority to hear and determine *inter alia* challenges to assessments of tax.

²⁰ *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834 (*Fullers* (HC)).

²¹ See n 4, at 51.

As an introductory comment his Honour noted the CIR and taxpayer followed the Privy Council in *Wattie (PC)*²² in accepting the *Hallstroms* test.

3.3.2 The submissions

The CIR argued, relying on the judgment of Dixon J in *Sun Newspapers Ltd v FCT (Sun Newspapers)*,²³ that the legal fees were related to an attempt by the taxpayer to obtain a capital asset or advantage in the form of the ferry service contract. This was to be distinguished from the individual contracts for services made by the ferry operator with individual passengers. The new Devonport service contract would potentially expand Fullers' profit-making structure.

Two major submissions were made by the taxpayer. First, they argued the purpose of the litigation (and hence the legal fees) was not to secure the contract for services, rather to make good alleged procedural deficiencies in the tendering process employed by the ARC (ie to set aside the result of an unlawful procedure and allow the tender process to begin again). Second, it was argued that even if the purpose of the litigation was to secure the contract, the contract would not have comprised a capital asset but, on the basis that Fullers' business consisted of providing passenger services, the contract would have been held on revenue account.

3.3.3 The decision

3.3.3.1 *The relevance of the facts*

Baragwanath J, at the outset of his judgment, reiterated the importance of the "precise analysis of the relevant facts of each case",²⁴ as illustrated by *BP Australia Ltd and Strick (Inspector of Taxes) v Regent Oil Co Ltd*²⁵ where the appellate committees of the Privy Council and House of Lords similarly constituted came to different conclusions concerning the tax treatment of trade tie payments. His Honour also referred to the Court of Appeal decision of *Birkdale*²⁶ where, on different facts again, the court held, with one exception, that the trade tie payments from Mobil to independent retailers were revenue payments.²⁷

²² (1998) 18 NZTC 13,991; [1999] 1 WLR 873, at 180. For a discussion of this case which concerned the tax treatment of a lease incentive paid to a firm of accountants to move into new premises see AJ Maples, "Lease Inducements" [1999] *New Zealand Law Journal* (March) 53 and AJ Maples, "Are Lease Incentives Taxable? – A Trans-Tasman Comparison" (2000) Vol 3:3 *Journal of Australian Taxation* 208 and Trombitas, see n 4, at 57-59.

²³ (1938) 61 CLR 337.

²⁴ See n 20, at 18,841.

²⁵ [1966] AC 295.

²⁶ See n 13.

²⁷ Other examples where the courts have come to different conclusions despite similar facts include the English case *Transco plc v Dyall (HMIT)* (2002) SpC 310 (*Transco*) and the New Zealand case *Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702 (PC); [2000] 3 NZLR 6 (*Auckland Gas*). In the former case the UK Special Commissioners came to a completely opposite conclusion to that of the Privy Council in *Auckland Gas*, treating the insertion of polyethelene piping into existing cast iron pipes as on revenue account. For a discussion of these cases see AJ Maples, (2002) "Comment: Just when you thought Auckland Gas was the final word on Replacement with Polyethylene Pipe" (2002) Vol 8:4 *New Zealand Journal of Taxation Law and Policy* 351. In

In determining cases concerning the capital-revenue distinction which are at the borderline, a correct assessment and understanding of the facts is therefore crucial as one fact may be sufficient to ‘tip the balance’ and distinguish the case under review from an apparently similar or identical decision.. As Lord Pearce observed in *BP Australia* in distinguishing capital and revenue:²⁸

“the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree.”

Green, commenting on the judgments of former President of the Court of Appeal Sir Ivor Richardson, also observes:²⁹

“What [his] judgments also highlight is the critical nature of the facts of a particular case ... at the end of the day the question is essentially one of analysing the facts of the particular case and the decision is often a finely balanced one... Furthermore, as is often the position, in many of the cases there was a crucial finding of fact or an agreed fact which ultimately determined the result in the case.”

3.3.3.2 *The capital-revenue tests*

Baragwanath J applied the following six tests to the facts before him:³⁰

- (a) whether the expenditure was for the purpose of carrying on an existing trade or rather to enable the taxpayer to enter that trade (essentially an application of the *Hallstroms* test). The early New Zealand decision of *Commissioner of Taxes v Ballinger*,³¹ which was cited with approval by Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation*,³² was mentioned under this test.

In this case Baragwanath J determined that the practical purpose and business objective of the expenditure was not just to win the court case but to secure the Devonport-Auckland ferry service as a major revenue producing addition to its business. The legal fees were “a set up cost to allow the respondent to enter the Auckland ferry market in a substantial way”.³³ This service would have produced for the company an entirely new revenue stream. His Honour

respect of the importance of the facts, one commentator on *Auckland Gas* wrote, there is: “... scope for the legal mind to tweak the facts slightly and produce a quite different outcome. What if, for example, [Auckland Gas] had inserted PE piping of a fractionally larger diameter so that the new piping fitted tightly within the old, *and acted as an inner lining*? Quite arguably this would not have produced a substantially different asset.”: A Borrowdale, Headnote and Casenote Digest “Re Commissioner of Inland Revenue v Auckland Gas Company Ltd and Poverty Bay Electricity (sic) Board v Commissioner of Inland Revenue” (May 1999) *Company & Securities Law Bulletin* 50, at 51.

²⁸ [1966] AC 224, at 264-265.

²⁹ R Green, “Sir Ivor Richardson and the Capital v Revenue Dichotomy” (2002) Vol 8:2 *New Zealand Journal of Taxation Law and Policy* 169, at 180.

³⁰ The criteria used by Baragwanath J are similar to those used in the Court of Appeal, see for example *McKenzies* (1988) 10 NZTC 5,233, at 5,236.

³¹ [1904] 23 NZLR 188. For a discussion of this case see n 4.

³² (1946) 72 CLR 634.

³³ See n 20, at 18,842.

considered that this was a strong pointer to the classification of the expenditure as capital.

- (b) whether the expenditure was recurrent or made once and for all, ie “in the traditional lawyers’ expression *uno flatu* (in a single breath).”³⁴

In this context his Honour distinguished between expenditure on the “[a]cquisition of a business by the slow process of conventional advertising and building up goodwill”, which is on revenue account, with acquiring “it by purchase” which is likely to be on capital account.³⁵ The expenditure was not recurrent but made on a “once and for all” basis - Fullers were attempting to secure the income stream *uno flatu* by securing the contract.

- (c) the distinction between the business structure and the ordinary process by which it is operated to obtain regular returns. Expenditure in respect of the former is a capital item while the latter is on revenue account. His Honour observed that expenditure as part of the process by which a business operates (and which is deductible) can maintain or over time develop an asset³⁶ or it may enhance a business (and still be deductible).³⁷ Baragwanath J noted the test overlaps with the second test.

Under this test, his Honour concluded the ferry contract would constitute “a major addition to the structure of the respondent’s business which it would operate to obtain regular returns from passenger fares.”³⁸

- (d) whether the expenditure was intended to result in an enduring asset. In this regard his Honour acknowledged that “enduring” is a relative term. Baragwanath J commented that “the oil cases show that according to circumstances a three-year contract may be properly characterised as either capital or revenue according to circumstances.”³⁹

In summing up his Honour observed that the fact that the expenditure did not produce an asset or advantage of an enduring nature “injects hindsight which is irrelevant (see the authorities cited in *Milburn NZ Ltd v C of IR* at pp 17,023-4 para [34-8]); what matters is its purpose.”⁴⁰

- (e) whether the expenditure is from fixed or circulating capital.

His Honour commented that this was seen to be difficult to apply and reference was made to the *BP Australia* decision and *Milburn NZ Limited v CIR (Milburn)*.⁴¹ For a discussion of this test see section 3.5 of this paper.

³⁴ Ibid, at 18,841.

³⁵ Ibid.

³⁶ His Honour cited *Bolam v Regent Oil Co Ltd* (1956) 37 Tax Cas 56 and *BP Australia* as examples.

³⁷ His Honour cited *Rhodesia Railways Ltd v Income Tax Collector* [1933] AC 368 as an example.

³⁸ See n 20, at 18,843.

³⁹ Ibid, at 18,841.

⁴⁰ Ibid, at 18,843.

⁴¹ (2001) 20 NZTC 17,017.

- (f) how the payment would be treated on ordinary principles of commercial accounting.

This did not provide his Honour with much assistance. For a discussion of the application of this test generally see section 3.6 of this paper.

3.3.3.3 *Uno flatu or gradually?*

His Honour's comments in respect of (b) and (c) above highlight an important point in determining issues on the capital-revenue border - the way the expenditure is undertaken is crucial to the treatment of the expenditure. Had Fullers' gradually built up its Auckland customer and revenue base, such expenditure arguably would have been deductible. Conceivably, over time it may have ended up with a revenue base equivalent in size to that it would have acquired had it won the ARC tender, yet that former expenditure could have been an ordinary operating expense. This is presumably his Honour's point in (c), expenditure in respect of a business operations can "develop an asset or it may enhance a business",⁴² and yet be deductible.

The impact of the way in which expenditure is conducted is also evident in cases concerning repairs and maintenance. The English case *Transco*⁴³ and the New Zealand Privy Council case *Auckland Gas*⁴⁴ are a good example of this principle. Both concerned the insertion of polyethelene piping into existing cast iron pipes, yet the former case held the expenditure was on revenue account while the latter on capital account. There were several factual differences between the two cases, the key being the way the work was carried out. In *Auckland Gas* there was the wholesale replacement (sector by sector) of substantial parts of the network of cast iron pipes with polyethylene pipe insertions, with the result that in substantial parts of the system gas was no longer distributed through cast iron pipes but polyethelene pipes. This work was based on a replacement programme. By contrast, *Transco* did not insert polyethylene pipes into whole sectors of its cast iron pipes; rather polyethylene pipe was only inserted into the fractured or worn part of the cast iron pipe leaving the remaining 'fit' cast iron portion(s) in place to continue to carry gas along with the inserted polyethylene portion. Despite the manner in which the work was done:⁴⁵

"[u]ltimately, [in *Transco*] over a period it is quite conceivable as the remaining cast iron portions of the pipes are also replaced that whole portions of the relevant part of the *Transco* network will be in fact comprised of polyethylene instead of cast iron (as in *Auckland Gas*), and thus the character of the network will have changed (or been upgraded). However, because of the way the repair is being carried out, such substantial change will occur on an incremental basis rather than whole areas being upgraded on a systematic basis. With replacement of the entire network occurring at the rate of 1 percent a year,⁴⁶ the considerable period over which the work is being carried out, no

⁴² See n 20, at 18,843.

⁴³ See n 27.

⁴⁴ Ibid.

⁴⁵ Maples, see n 27, at 361.

⁴⁶ This replacement rate of 4 percent over the relevant period compares with the insertion of polyethylene pipe into 23 percent of the total mains and 32 percent of the steel services in the five years at issue in *Auckland Gas*.

doubt was also influential. However, in the author's view, even if the Transco replacement programme occurred at an accelerated rate, the different 'piecemeal' approach to the carrying on of the repair work would still have produced the same court finding."

3.3.3.4 Conclusion

Overall, his Honour was not persuaded by the TRA's analysis. As to the TRA's view that the occasion of the expenditure was to enforce a claim to fair contractual process, he observed that that was only part of the total object of the litigation which was to secure the ferry contract. Further, Baragwanath J considered that, as what matters is purpose, the fact that the expenditure produced no asset or advantage of an enduring nature was irrelevant.

Baragwanath J also disagreed with the TRA's view that the expenditure was not related to the structure of the business. Although operating a business so as to build it up does not require conventional revenue expenditure to be reclassified as capital, a dominant purpose of acquiring assets to ensure a future revenue flow is likely to lead to classification of the expenditure as on capital account. His Honour also considered that how Fullers would have treated the profit centre of a new stand-alone Devonport ferry operation did not determine the essential question of the object of the expenditure made to acquire it.

Accordingly, Baragwanath J was satisfied that the object of the expenditure was to secure a capital asset and therefore his Honour allowed the appeal.

3.4 The Court of Appeal

Fullers' appealed to the Court of Appeal. The appeal was heard before Glazebrook J (who delivered the court's judgment), O'Regan and Robertson JJ.

3.4.1 The arguments

Counsel for the taxpayer submitted that Baragwanath J had applied the wrong conceptual framework so that his decision was wrong at law. In particular it was submitted:

- (i) The object of the litigation was to enforce the process contract and not to secure the ferry contract, and realistically the most that could have been achieved by the litigation was an award of damages;
- (ii) The ferry contract was, in any event, merely one of a number of contracts and thus any expenditure to secure it would be on revenue account;
- (iii) Any damages received as a result of the litigation would have been for loss of profits and therefore on revenue account. The expenditure to secure that result was therefore deductible.

The CIR submitted that:

- (i) The business objective of the litigation must have been to secure the contract or damages to compensate for its loss and that the correct focus was the ultimate business objective and not the immediate means employed to achieve the business ends;
- (ii) The legal fees could be either capital or revenue in nature depending on the purpose for which they were incurred. In this case the expenditure was incurred to secure the contract for the Devonport ferry service and must be on capital account. The fact that this objective was not achieved was irrelevant;⁴⁷
- (iii) damages for the permanent loss of a capital asset, such as damages for the loss of the ferry contract, were on capital account.

3.4.2 The Court of Appeal's findings

The Court of Appeal rejected Fullers' submissions essentially for the reasons set out in Baragwanath J's judgment and in the IRD's submissions.

In respect of the taxpayer's first submission, their Honours' did not believe the matter could be looked at so narrowly. From a practical business point of view the object of the litigation was to enforce the process contract as a step to secure the ferry contract or damages equivalent to the value of the ferry contract otherwise there was no point in issuing the litigation.

Their Honours' did comment that even if the object of the litigation had merely been to enforce the process contract, this was designed to ensure a chance of securing the contract or compensatory damages. On the basis of how the claim was framed:⁴⁸

“the assumption was that, were the process contract properly enforced, the ferry contract would have followed, given the preferred bidder status and Fullers' willingness to abide by the conditions. There was thus no substantive difference between the process contract and the ferry contract itself.”

In rejecting Fullers' second submission, their Honours' considered “it *incontrovertible* that the ferry contract would have been on capital account in the particular (and rather unusual) circumstances of this case.”⁴⁹ (emphasis added) The ferry contract was a long term monopolistic contract, representing a major expansion of Fullers' business into the Auckland area. It was expected that it would double the operating revenue of the marine division, a division which contributed some 60 percent of Fullers' revenue. Accordingly any expenditure to secure the contract was on capital account, whether or not it resulted in the contract being obtained. The fact that the litigation was unsuccessful did not change the nature of the expenditure.

With respect to the third point concerning damages, their Honours' stated that what was claimed were damages for the loss of a capital asset, the ferry contract. Although the value of capital assets is often calculated on the basis of discounted cashflows,

⁴⁷ Citing *Milburn* (2001) 20 NZTC 17,017, at 17,023–24 and *John Fairfax & Sons Ltd v FC of T* (1959) 101 CLR 30, at 49 as authority.

⁴⁸ *Fullers* (CA), see n 7, at 19,725.

⁴⁹ *Ibid*, at 19,726.

that did not turn a claim into one for loss of profits.⁵⁰ It remained a claim for loss of a capital asset. It was irrelevant that any income from the contract, if it had been awarded, would have been on revenue account as income from any capital asset is on revenue account.

The wording used by the Court of Appeal “... it is incontrovertible...” is very strong and raises the issue of what is and what is not a significant contract – where is the dividing line? In *Fullers* case the contract would have increased the taxpayer’s turnover by approximately 60 percent. Would the outcome of the case have been different had the contract increased turnover by a lesser figure, for example 10 or 20 percent. This may be an issue for *inter alia* accountancy and law firms tendering to supply accounting, audit or legal services. If a tender, if successful, would have a significant impact on the firm’s turnover, would the expenditure (including staff costs) in preparing the tender be capital expenditure? This will depend in part on the term of the contract. A contract for a period of 3 years may be indeterminate; a period of five years may indicate capital expenditure. The fact that the firm is able to service the contract from existing staff (perhaps when it has ‘quiet patches’) and resources is irrelevant, *Fullers* required no additional infrastructure. In *Fullers* case the tender would have given them monopolistic rights for a period – a successful audit tender or tender to provide legal services may provide similar ‘monopolistic’ rights.

3.5 The fixed and circulating capital test

Baragwanath J in the High Court in *Fullers* (HC) referred to difficulties with applying the test in *BP Australia*⁵¹ and *Milburn*.⁵²

3.5.1 Background

The distinction between fixed and circulating capital is found in Adam Smith’s *An Inquiry into the Nature and Causes of the Wealth of Nations*⁵³ and was initially used in company law cases involving the payment of dividends.⁵⁴ While it found support in

⁵⁰ *Borthwick*, n 13, is an example of this principle. In this case, the taxpayer received an amount as consideration for the variation and partial surrender of rights under a long term supply contract. The amount was determined through a discounted cash flow calculation of the expected receipts for the balance of the contract term. The Court of Appeal determined the amount received was for the surrender of a capital asset (the supply contract) and therefore on capital account.

⁵¹ See n 14.

⁵² See n 41.

⁵³ (1983, Penguin), at 374. For a discussion of this test and its origins see J McDermott and J Prebble, “Circulating Capital: a Judicial Label” (2003) Paper presented at 15th Annual Australasian Tax Teachers Association Conference,; available at <http://pandora.nla.gov.au/tep/23524> and AJ Maples, “The Fixed and Circulating Capital Test: Down and Now Out in New Zealand?” (2005) Vol 11:3 *New Zealand Journal of Taxation Law and Policy* 315.

⁵⁴ The first such case was *Lee v Neuchatel Asphalte Co* (1889) 41 ChD 1 in which a shareholder unsuccessfully opposed the payment of a dividend out of the previous year’s surplus on the basis that the capital of the company had been lost and that, until the loss had been made good no dividend could be paid. The court held there was no legal requirement for a company to make up lost capital before paying dividends so long as the company was trading profitably and could still pay its creditors. In reaching its conclusion the court distinguished between fixed (or sunk) capital and circulating capital, saying that the former could be left to waste or diminish without being

a number of similar cases it has also been criticised in a number of company law cases.⁵⁵

The fixed and circulating capital test has been utilised by the courts in the tax context since it was adopted by Viscount Haldane in the early House of Lords decision *John Smith & Son v Moore (John Smith)*.⁵⁶ In this case, Mr John Smith, who carried on the business of coal and shipping agents (as a sole proprietorship), died. Under the terms of his trust disposition and settlement, his son took over the business on the condition he pay to the trustees a sum equal to the net assets of the business but excluding any goodwill. Included in the assets acquired by the son were certain unexpired contracts with colliery owners for the supply of coal at fixed prices, all of which contracts expired on or before a specified date. The son paid £30,000 for these contracts.

The House of Lords (Viscount Finlay dissenting) held this expenditure was on capital account. Viscount Haldane, in particular, referred to Smith's definition of fixed and circulating capital.⁵⁷ Applying Smith's distinction between the two types of capital to the facts his Lordship stated that it was not by selling the contracts that the taxpayer had acquired from his father that he made profits; it was by retaining those contracts - they were part of his fixed capital, not the circulating capital.⁵⁸

The concept has been accepted in a number of subsequent cases including *Mallet v Staveley Coal & Iron Co Ltd*,⁵⁹ and *Anglo-Persian Oil Co Ltd v Dale (Anglo-Persian Oil)*,⁶⁰ and, of most significance for New Zealand tax law, *BP Australia*⁶¹ where it was listed by Lord Pearce as one of the tests to determine the capital-revenue boundary. The test has been recognised and applied in a number of New Zealand cases including in the High Court⁶² and Court of Appeal. The most significant

replaced. McDermott and Prebble note that a different but similar concept had earlier appeared under the name of "floating capital" in *Bouch v Sproule* (1887) 12 App Cas 385, 393-394 per Lord Herschell: McDermott and Prebble, *ibid*, at 5.

⁵⁵ See for example Scrutton LJ in *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266 who stated the distinction had been misunderstood (297) and, agreeing with Lord Halsbury in *Dovey v Cory* [1901] AC 477 that the concepts were not appropriate in concrete cases.

⁵⁶ [1921] 12 TC 266. See further R Krever, "Capital or current: The tax treatment of expenditures to preserve a taxpayer's title or interest in assets" (1986) Vol 12 *Monash Law Review* 49.

⁵⁷ According to Viscount Haldane: "Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters. The latter circulates in this sense.": *James Smith*, *ibid*, at 282.

⁵⁸ Viscount Haldane commented: "... [The taxpayer] had bought as part of the capital of the business his father's contracts. These enabled him to purchase coal from the colliery owners at what we were told was a very advantageous price... and reselling it for more, but he was able to do this simply because he had acquired among other assets of his business, including the goodwill, the contracts in question. It was not by selling these contracts, of limited duration though they were, it was not by parting with them to other masters, but by retaining them, that he was able to employ his circulating capital in buying under them. I am accordingly of opinion that, although they may have been of short duration, they were none the less part of his fixed capital.": *ibid*, at 282 - 283.

⁵⁹ [1928] 13 TC 772.

⁶⁰ [1931] All ER 725.

⁶¹ [1966] AC 224, 264-265.

⁶² *AA Finance Ltd v CIR* (1993) 15 NZTC 10,171 (whether gains made by a finance company for the sale of government stock were assessable income); *Christchurch Press Company Ltd v CIR* (1993) 15 NZTC 10,206 (whether wages of employees involved in plant installation were deductible) and *Lockwood Buildings Ltd v CIR* (1996) 17 NZTC 12,483 (whether management fees were deductible).

discussion of the test in the Court of Appeal can be found in *McKenzies*⁶³ and *CIR v Inglis (Inglis)*.⁶⁴

The test has been criticised in a number of cases including by Lord Macmillan in *Van den Berghs Ltd v Clark*⁶⁵ who did not find the test “very helpful”. In *BP Australia*, although their Lordships applied the test, in that case they commented that:⁶⁶

“This test of fixed and circulating capital is not always helpful and not always easy to apply or appropriate; in some circumstances it can be critical, but in others it is not very easy to use or to apply; it is *not very significant*.” (emphasis added)

3.5.2 The two strands

Harris et al⁶⁷ note that this test has been considered in two different situations. First, “whether a particular item of expenditure was made *from* fixed or circulating capital...”⁶⁸ (emphasis added) (the ‘source of the funds’ application). Under this application, the source of the funds used provides an indication of the character of an item of expenditure. Thus money provided from the fixed capital of a business would constitute capital expenditure while money provided from the circulating capital would be revenue. The second application is whether payment was “...made *for* fixed or circulating capital...”⁶⁹ (emphasis added) (the ‘use of the funds’ application). The IRD recognise the two formulations of the test and that it may not be as useful as other tests.⁷⁰

⁶³ In *McKenzies* case, which concerned the deductibility of a lump sum payment made by a lessee to the lessor in consideration for the surrender of the lease, Richardson J acknowledged the test as one of the *BP Australia* factors and that it had received mixed judicial support: *McKenzies* see n 13, at 5,240-5,241. His Honour aligns a ‘use of funds’ application of the test to the identifiable asset test (the former simply being a restatement of the latter): *Maples*, see n 53, at 338-339.

⁶⁴ (1992) 14 NZTC 9,180. *Inglis* concerned the deductibility of share losses incurred by a management consultant. Under then section 65(2)(e) of the Income Tax Act 1976 (“ITA 1976”) profits or gains derived from the sale of personal property were assessable income where the property was acquired for the purpose of sale. Cooke J and McKay J in *Inglis* supported the use of the test, the former arguably extended its application: McDermott and Prebble, see n 53, at 18.

⁶⁵ [1935] AC 431, 443. Krever comments that the fixed and circulating test: “... largely fell from favour after Lord Macmillan suggested in *Van den Berghs Ltd. v Clark* [1935] A.C. 431 that the distinction was not helpful in deciding the issue for tax purposes. Nevertheless, it is often revived, particularly in Australia. See, for example, the dissenting judgment of Barwick C.J. in *London Australia Investment Co. v. Federal Commissioner of Taxation* [1974] A.T.C 4213.”: see n 56.

⁶⁶ See n 14, at 237.

⁶⁷ G Harris, C Ohms, C Plunket, A Sharp and N Smith, *Income Tax in New Zealand* (Wellington, Brookers Ltd, 2004), at 516.

⁶⁸ *Anglo-Persian Oil* is cited as an example of this application of the test.

⁶⁹ *Mallet v Staveley Coal & Iron Co Ltd* [1928] 13 TC 772 is cited as an example of this application of the test. The High Court decision in *Christchurch Press* (1993) 15 NZTC 10,206 is another case where this application was adopted (at 10,210).

⁷⁰ IRD, “Year 2000 expenditure – income tax deductibility Public Ruling BR Pub 98/4” (1998) Vol 10:11 *Tax Information Bulletin* 3, 8. See also IRD, “Financial Planning Fees – Income Tax Deductibility” (2000) Vol 12:5 *Tax Information Bulletin* 26; and IRD, “Deductibility of Sponsorship Expenditure” (2002) Vol 14:9 *Tax Information Bulletin* 33.

3.5.3 Wild J in *Milburn*

Baragwanath J in *Fullers* observed that the fixed and circulating capital test had proven difficult to apply, citing *BP Australia*⁷¹ and Wild J in *Milburn*.⁷² The second case noted, *Milburn*, contains the strongest recent criticism of the test (the source of funds application).⁷³ The case concerned cement manufacturer Milburn NZ Ltd which incurred expenditure on obtaining the consents or licences necessary to develop three sites into quarries for aggregate and lime for use in its cement and concrete businesses. The High Court concluded that the amounts were capital expenditure because they were part of the cost of creating the permanent structure which produced Milburn's taxable income. The consents and licences were enduring and not recurrent in nature. While his Honour believed the expenditure was "reasonably clearly capital"⁷⁴ and therefore resort to the *BP Australia* indicia was unnecessary, Wild J briefly considered each test to confirm whether his initial conclusions were correct.

In respect of the fixed and circulating capital test his Honour commented:⁷⁵

"With all respect to the eminent economists and Judges who have propounded this test, I am unable to view it as compelling, or even useful. It is essentially a 'source of funds' test. I cannot see any logical or reliable nexus between the source of monies, and what they are spent on. It is well established that the character of expenditure (capital or revenue) by a payer taxpayer does not determine its character as a receipt in the hands of a payee taxpayer: *Tasman Forestry Limited v C of IR* (1999) 19 NZTC 15,147 (CA) at p 15,153 ... Although the monies here are within a single taxpayer's business, the position seems to me analogous. Thus, where the monies came from is no reliable guide in determining the nature of their expenditure."

Expert accounting evidence was presented for the taxpayer that the payments were from circulating rather than fixed capital. While this pointed to a revenue characterisation Wild J observed that it was "also indicative of the long and soundly established nature of the business of" the taxpayer.⁷⁶

His Honour concluded his discussion of the test stating: "I prefer to disregard this test and wonder whether it might not be given a quiet burial?"⁷⁷

3.5.4 Baragwanath J in *Fullers* (HC)

Baragwanath J did not go as far as Wild J in *Milburn*⁷⁸ but did question the test's continued relevance, support for this view being provided from an 'outside' source – the 1993 company law changes:⁷⁹

⁷¹ See n 14, at 269.

⁷² See n 41, at 17,025-17,026.

⁷³ There has been prior recognition by the High Court of the criticism of this test, see for example Sinclair J in *Trevathan v CIR*; *Western Developments Ltd v CIR* (1984) 6 NZTC 61,746, at 61,748.

⁷⁴ See n 41, at 17,025.

⁷⁵ Ibid, at 17,025 – 17,026.

⁷⁶ Ibid, at 17,026.

⁷⁷ Ibid, at 17,025.

⁷⁸ Ibid.

“The abandonment of the concept of nominal capital by the Companies Act 1993 points to the unreality of treating the source of funds as a significant guide to whether for tax purposes the acquisition is to be treated as on capital or revenue account.”

Rather than focusing on the source of funds, Baragwanath J stated (in *Fullers* (HC)).⁸⁰ “What matters is rather the purpose of the expenditure than its source.”

Baragwanath J did consider the test in the case – it supported a revenue finding; however, in the light of his earlier comments, his Honour stated that the source of the payments (in this case from gross profit receipts) was “of little significance”.⁸¹

It is a little ironic that Baragwanath J draws support for questioning the test’s relevance from changes in company law given that the test has its foundations (at least in the law) in company law.

3.5.5 The Court of Appeal in *Fullers*

Their Honour’s in the Court of Appeal did not discuss any of the six capital-revenue tests referred to by Baragwanath J. Counsel for the IRD did submit in respect of the fixed and circulating capital test, that it:⁸² “is not particularly helpful in either way on the facts of this case” and that “this test has been criticised in New Zealand – see *Milburn*”. As the Court of Appeal did not specifically address this (or any of the tests) the Court’s view presumably is unchanged ie the test may apply in some situations. It is unfortunate that the Court did not address the criticisms of the test. This was the first significant opportunity for the Court of Appeal to consider the application of the test since Wild J’s comments in the High Court in *Milburn*. As indicated, preceding *Milburn* there is relatively limited comment from a number of recent Court of Appeal cases on the test overall indicating support for it (in particular *McKenzies*⁸³ and *Inglis*⁸⁴).

3.5.6 The future for the test

Due to the court hierarchy in New Zealand whether in fact this test continues to be used in New Zealand ultimately depends on the position adopted by the Court of Appeal and the Supreme Court of New Zealand in the future. At the time of writing no tax cases have been heard by the Supreme Court⁸⁵ concerning the capital-revenue

⁷⁹ See n 20, at 18,841. The Companies Act 1993 abolished the concept of par value and, as a consequence, the concept of nominal capital. “The perceived safeguards provided by the concept of par value in practice proved to be illusory. Instead of shares having a par value, the directors of a company must determine the consideration for which shares are to be issued and must resolve that in their opinion the consideration for and terms of the issue are fair both to the company and existing shareholders.”: CCH New Zealand Ltd, *New Zealand Company Law and Practice*, (CCH New Zealand) (electronic database), para 3-140.

⁸⁰ Ibid.

⁸¹ Ibid, at 18,843.

⁸² See n 7, at 19,724.

⁸³ See n 13.

⁸⁴ See n 64.

⁸⁵ The Supreme Court of New Zealand commenced hearing cases from 1 July 2004.

distinction and therefore at this stage there is no indication of the approach likely to be taken by the Court. Harley observes:

“In general, and perhaps particularly in the tax field, not many cases will justify applications for leave to appeal to the Supreme Court. The existence of concurrent findings of fact in the courts below will preclude many such appeals.”⁸⁶

In the author’s view the test, as interpreted as a ‘source of funds’ test, has arguably outlived its usefulness in New Zealand as an indicator of the capital-revenue divide. This application of the test is unlikely ever to be decisive; at best, it may confirm a conclusion based on other indicia from *BP Australia*. In this context McDermott and Prebble similarly believe the test is “unsound”⁸⁷ and support Wild J’s comment that the test be given a decent burial.⁸⁸

The test, as a “use of the funds” application, in the author’s view when applied in this manner is a restatement and application of the identifiable asset test. Support for the contention of the link between the ‘use of funds’ interpretation and the identifiable asset test is drawn from the approach of the Court of Appeal in *McKenzies*.⁸⁹ The identifiable asset test has also received the support of the Court of Appeal in *Wattie v CIR*.⁹⁰ This interpretation of the fixed and circulating test will remain, whether or not under this name, certainly in the form of the ‘identifiable asset’ test.⁹¹

3.6 Ordinary principles of commercial accounting

3.6.1 The usefulness of this test

How a payment would be treated on ordinary principles of commercial accounting is one of the guiding principles to determining the character of expenditure,⁹² and was recognised by Baragwanath J in *Fullers* (HC) in that capacity. There are New Zealand cases where the courts have referred or had regard to financial accounting principles to assist in determining the issue at hand.⁹³ One such example is *Birkdale* where the

⁸⁶ GJ Harley, “The Expected Impact of the Supreme Court of New Zealand on Tax Cases” (2006) Vol 22 *New Zealand Universities Law Review* 76, at 101.

⁸⁷ McDermott and Prebble, see n 53, at 25.

⁸⁸ Ibid, at 26.

⁸⁹ See n 13.

⁹⁰ (1997) 18 NZTC 13,297.

⁹¹ The distinction between fixed and circulating capital is also useful as a descriptive term, essentially as an alternative to distinguishing between “capital assets” and “stock-in-trade”: see *Case W24* (2004) 21 NZTC 11,387. As noted by the IRD: “‘Fixed capital’ and ‘circulating capital’ are relevant terms to a business that has fixed plant and circulating capital that are turned over while making profits and would apply to a business investor.”: IRD, “Financial Planning Fees – Income Tax deductibility” (2000) Vol 12:5 *Tax Information Bulletin* 26, at 35.

⁹² See *McKenzies* and *BP Australia*.

⁹³ It is also accepted in New Zealand case law that generally accepted accounting principles and ordinary commercial practices are to be applied in the computation of income for tax purposes to the extent the legislation allows: *Lowe v CIR* [1981] 1 NZLR 325, at 345; (1981) 5 NZTC 61,006, at 61,024. In addition there is currently a trend in New Zealand to explicitly use accounting principles by incorporating them into the tax system: B Lemmens, “Aligning Research and Development Expenditure Tax Treatment with Accounting Treatment: Comparing New Zealand and International Approaches”, (2002) Vol 8:1 *New Zealand Journal of Taxation Law and Policy*

Court of Appeal commented that the accounting treatment in that case provided a minor degree of support for the conclusion that the trade-tie payments were revenue.⁹⁴ In *CIR v Mitsubishi Motors New Zealand Ltd (Mitsubishi)*⁹⁵ the Court of Appeal commented that financial accounting principles and good commercial practice could not be substituted for the statutory test of deductibility “but they may assist ‘in ascertaining the true nature and incidence of the item as a step towards determining whether it answers the test’...”.⁹⁶

However, the New Zealand courts have traditionally been more reticent to use and rely on this test than their English counterparts.⁹⁷ For example, Richardson J, in *CIR v Farmers’ Trading Co Ltd*⁹⁸ cautioned against undue reliance on accounting principles and commercial practice.⁹⁹ Similarly, in *Birkdale*, Blanchard J stated that the proper accounting treatment was not determinative.¹⁰⁰ Wild J in the High Court in *Milburn*, also commented that the correct accounting treatment was not determinative of the correct tax treatment and when two legitimate, but opposing accounting treatments are available, accounting principles ceased to be a useful guide to tax treatment.¹⁰¹

In *Fullers*,¹⁰² Baragwanath J did not find the accounting treatment adopted by the taxpayer of particular assistance. Neither the taxpayer nor the CIR saw the accounting treatment as particularly relevant in the current situation. His Honour considered the accountants’ treatment of expenditure as being on revenue account was simply an expression of their opinion which differed from the position they had taken in the preceding years.¹⁰³

Even where the accounting and tax treatment is the same, this may be for quite different reasons. Counsel for the CIR submitted in *Fullers* (CA)¹⁰⁴ that for accounting purposes what was important in determining the treatment of the expenditure was the outcome of the expenditure ie, the accounting definition of an

33. Lemmens cites the research and development tax amendments and the trading stock reforms introduced in the late 1990s as examples of this trend (at 33).

⁹⁴ See n 13, at 15,991 (Blanchard J).

⁹⁵ [1994] 2 NZLR 392 (CA).

⁹⁶ Ibid, at 397.

⁹⁷ See for example *Milburn* n 41, at 17,026 where the CIR submitted (and accepted by Wild J) that the accounting principles test has more relevance in the United Kingdom than New Zealand. See also *CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351, at 12,352-12,353 (PC) where Lord Hoffman explained the reason for the difference in emphasis between the courts in New Zealand and the United Kingdom.

⁹⁸ [1982] 1 NZLR 449, at 455; (1982) 5 NZTC 61,200, at 61,206 (CA).

⁹⁹ For a further discussion of the Rt Hon Sir Ivor Richardson’s views on this issue see Ivor Richardson, “The Concept of Income and Tax Policy”, [1990] 4 *Canterbury Law Review* 203, at 208-9 and Ivor Richardson, “The Impact and Influence of Accounting and Economic Principles on Taxation Law”, (1998) Vol 4:1 *New Zealand Journal of Taxation Law and Policy* 18.

¹⁰⁰ See n 13, at 15,991 (Blanchard J).

¹⁰¹ See n 41, at 17,028.

¹⁰² See n 20.

¹⁰³ When the legal fees were first incurred they were shown as an “abnormal item” (although in terms of the accounting standards it was acknowledged it would have been more appropriate to term it as an “extraordinary item”) and deductible for accounting purposes. For tax purposes the fees were added back as non-deductible in two of the relevant years and as deductible in the third year on the basis inter alia that the substance of the claim was based on a loss of profits calculation.

¹⁰⁴ See n 7, at 19,725.

asset was not met in the year so a deduction was claimed. For tax purposes, the important factor was what the expenditure was designed to achieve from a business perspective.

Shewan and Boyce note that the scheme of the income tax legislation has:¹⁰⁵

“...led the Court of Appeal to the view that there was significantly more scope for the influence of accounting principles and commercial practices on the income side of the tax equation than for deductions.”

From the policymakers, it is also of significance that the New Zealand Government rejected a proposal during the rewrite of the core provisions to include an express requirement to have regard to accounting principles if an item's tax treatment was unclear.¹⁰⁶ Shewan and Boyce conclude that “accounting principles should only be used as a reference point for tax” and ultimately tax liability should always be determined according to the wording of the legislation.¹⁰⁷

While therefore the accounting treatment is one of the tests used in determining the capital-revenue expenditure it clearly will not always be relevant and when it may be useful will normally be in support of the other tests, it will not be determinative.

3.6.2 International Financial Reporting Standards

New Zealand is following the worldwide move to adopt International Financial Reporting Standards (IFRS) for financial reporting purposes. In New Zealand the adoption of IFRS has been allowed from 1 January 2005, and is mandatory for financial reporting periods beginning on or after 1 January 2007. This will have an impact on some current taxation policies as these are linked to some accounting practices. In September 2006 the Policy Advice Division of the IRD and the New Zealand Treasury released an officials' issues paper considering the “tax policy issues that could arise from the adoption of IFRS within the context of existing policy on alignment between tax and accounting.”¹⁰⁸ The officials' issues paper does not address the impact that IFRS may have insofar as the capital-revenue distinction is concerned.

¹⁰⁵ J Shewan and P Boyce, “Derivation and Deductions Revisited”, (2002) Vol 8:2 *New Zealand Journal of Taxation Law and Policy* 181, at 189-190 referring to *CIR v Farmers' Trading Co Ltd* [1982] 1 NZLR 449, at 456-7; (1982) 5 NZTC 61,200, at 61,207-8.

¹⁰⁶ Ibid, at 191.

¹⁰⁷ Ibid.

¹⁰⁸ The Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury, “The tax consequences of adopting financial international financial reporting standards” (Wellington, September 2006), 1; also available at <http://www.taxpolicy.ird.govt.nz/news/archive.php?year=2006&view=468>. Legislative changes that need to be made as a result of IFRS are intended to be enacted for the 2008-2009 income year. The issues paper specifically addresses the impact of IFRS' on the trading stock rules, research and development expenditure, financial arrangements, revenue recognition and generally accepted accounting principles (GAAP). The officials' issues paper comments that “it does not propose to consider a comprehensive alignment of tax legislation with accounting standards at this time.” (at 1, 6).

As the incorporation and application of the test in the capital-revenue area is based on case law rather than explicitly stated in the tax legislation (unlike, for example, the trading stock valuation rules which are specifically aligned in the ITA 2004 with an accounting standard) the continued application of this test presumably will be determined by the courts. However, depending on the direction that IFRS' take, over time there may be a greater or lesser use of accounting standards in the capital-revenue area both here and overseas.¹⁰⁹

4.0 CASE X26¹¹⁰

4.1 The facts

The taxpayer was a member of a two-person partnership. In 1989 the partnership purchased the leasehold of a building for \$655,000 (plus GST) and, in 1997, the freehold of the land for \$177,000 (plus GST). In a letter of 18 March 1999 the partners were advised by the Wellington City Council that the building failed to comply with the earthquake strength capacity required under the 1965 Loading Code. The conclusion was that the building may collapse in a moderate earthquake. The letter continued:

“Section 66 of the Building Act states that in such a situation, Council could barricade your building and give notice for the owner to reduce or secure any danger within a specified period of time...”

The policy of the Council was to allow property owners some time to remedy any defects prior to invoking its powers under the Building Act 1991.

In addition, shortly after acquiring the freehold, the partners were advised that the building was a Heritage property. As such the partners could get financial assistance from the Council in undertaking the earthquake strengthening. To obtain the assistance, an encumbrance would be placed upon the title to preserve the building.

The partnership engaged its own consulting engineers to undertake a feasibility study outlining the weaknesses of the building and the work required to bring it up to the required level of seismic strength. The report (in October 1999) identified the following weaknesses:

- The floors and roof were not adequately tied to the brick walls,
- There was minimal seismic resistance at ground level at the front of the building, and
- There was inadequate seismic resistance in the rear walls.

The report also recommended the following remedial work:

- A new structural steel and concrete frame towards the front of the building,
- Post-tensioned strands and a steel frame on the rear brick wall,

¹⁰⁹ The issues paper comments concerning GAAP: “The use of ‘generally accepted accounting practice’ in tax legislation is ambulatory in that as GAAP changes with the adoption of IFRS for financial reporting purposes, these changes will be accepted for taxation purposes. Legislative changes to deal with unexpected tax consequences arising from these provisions after the adoption of IFRS should be considered where appropriate.” (Ibid, at 3).

¹¹⁰ (2006) 22 NZTC 12,303.

- New steel in floor bracing and wall/floor trim,
- Drilled and grouted reinforcing to the front parapet wall,
- Gib clad bracing walls added to the second floor, and
- Roof framing and sarking tied into the parapet walls.

This work was carried out at a total cost of \$107,210.45. The council provided \$45,000 as financial assistance, with the partnership paying the balance. This project was planned to take the consulting engineers six to eight weeks to complete, but took about 12 weeks.

The partnership claimed a deduction (under s BD 2 ITA 1994), as repairs and maintenance, for the net cost to the partnership of the strengthening work in the income tax year in which it was incurred. The IRD considered that the work went beyond the repair and maintenance of the existing asset and brought into existence a better asset than had previously existed, namely, a seismically strengthened building with an extended life expectancy. As such the expenditure was on capital account and depreciable, but not deductible. The IRD adjusted both the partnership returns and the two partners' assessments to reflect that conclusion. One partner disputed that adjustment. The other partner has accepted the CIR's assessments and was not a party to this dispute. The case was heard by the small claims jurisdiction of the TRA.

4.2 The decision of the TRA

4.2.1 Small claims jurisdiction

Every TRA has two levels of jurisdiction – general and small claims. As in the general jurisdiction, cases in the small claims jurisdiction are heard by an Authority judge. The primary objective of the small claims jurisdiction is to provide a simple, fast-track procedure for hearing small, 'simple'¹¹¹ revenue cases.

A taxpayer may elect to have a dispute heard in the small claims jurisdiction where:

- the facts are clear and not in dispute,
- the tax to pay or the tax effect¹¹² does not exceed \$30,000,
- there are no "significant legal issues of precedent" involved.¹¹³

In this case the facts were clear. The tax in dispute (calculated on half of the expenditure of \$62,210.45) was below the threshold.¹¹⁴ In respect of the third issue, his Honour commented:¹¹⁵

¹¹¹ Cases where the facts are clear and there are no precedential implications are referred to as 'simple' cases.

¹¹² "Tax effect" means the value of an adjustment or amendment to an assessment calculated by applying the taxpayer's applicable marginal rate (s 13B(2), Taxation Review Authorities Act 1994 (TRAA 1994)). The \$30,000 threshold applies to each case not revenue type. Thus, where a dispute concerns three types of taxes for a taxpayer, if the combined value of the tax in dispute exceeds the threshold, even though the disputed tax for each issue may be below the threshold, the dispute cannot be heard in the small claims jurisdiction.

¹¹³ Section 13B(1), TRAA 1994.

¹¹⁴ The threshold was increased from \$15,000 to \$30,000 with application to disputes that commenced under the relevant procedure in the TAA 1994 on or after 1 April 2005.

¹¹⁵ See n 110, at 12,316.

“Accordingly, I deal with it under that [small claims] jurisdiction but observe that (in terms of s 13B of the Taxation Review Authorities Act 1994 — which creates that small claims jurisdiction) significant legal issues for the general taxpayer are involved so that the small claims jurisdiction seems inappropriate.”

The meaning of the phrase “significant legal issues of precedent” used in the TRAA 1994 was considered in *Case W32*¹¹⁶ which concerned an application by the CIR to have a case transferred from the small claims to the general jurisdiction of the TRA. Willy DCJ stated:¹¹⁷

“It is difficult to know quite what is meant by a ‘significant legal issue of precedent.’ It might mean that the legal issue raised must be ‘significant’ to the administration of the particular revenue statute, or it might mean that the precedent created must be significant and not some minor addition to the relevant law, or it might be that the word ‘issue’ (always a difficult chameleon of a word) is otiose.”

His Honour favoured the latter construction – the word ‘issue’ should be ignored and the phrase to read ‘a significant legal precedent’. Of importance to the present case, Willy DCJ stated the question to determine whether or not the case should be transferred was:¹¹⁸

“...does this case involve questions of disputed fact or will the outcome create an important precedent which will assist the Commissioner and later taxpayers in their understanding of the relevant legislation.”

Decisions of the small claims jurisdiction differ from those made under the Authority’s general jurisdiction in a number of ways:

- (a) the decisions are not normally published.¹¹⁹ However, Regulation 18 of the Taxation Review Authorities Regulations 1998 (the Regulations) permits an Authority to publish a decision or authorise its publication (hence the publication of this case).
- (b) they have no precedential effect in the sense that they may not be cited as authority in any subsequent case or for any other purpose.¹²⁰ They can only be used as precedent by the affected taxpayer.¹²¹

¹¹⁶ (2004) 21 NZTC 11,318.

¹¹⁷ Ibid, at 11,320.

¹¹⁸ Ibid, at 11,321.

¹¹⁹ A New Zealand Government Consultative Document considered whether decisions of the small claims jurisdiction should be published, even in a summarised form, along the lines of a case head note with details of the taxpayer’s identity removed: New Zealand Government, “Resolving Tax Disputes: Proposed Procedures – A Government Consultative Document”, (Wellington, New Zealand Government, December 1994), para 7.42. This was rejected on the basis that publication in a summarised form could be misleading, causing taxpayers to draw incorrect conclusions (para 7.43). The Government considered that publication of small claims decisions was not necessary as they are non-precedential.

¹²⁰ Regulation 18(5).

- (c) the decision is final - there is no right of appeal from a decision made by a TRA in its small claims jurisdiction.

It is surprising, given the Willy DCJ's interpretation of "significant legal issue of precedent" in *Case W42* and the fact that Barber J in *Case X26* believed there were "significant legal issues" involved in that case that his Honour heard the case in this jurisdiction where the decision cannot be used as precedent. An Authority may, of its own motion, transfer a case from the small claims jurisdiction to either its general jurisdiction or to the High Court.¹²² A challenge will be transferred if *inter alia* it "involves or may involve significant legal issues of precedent".¹²³ The TRA has similar authority to transfer a case from the small claims jurisdiction at the request of the CIR,¹²⁴ however, it would appear that no such request to the TRA was made.

As the decision was decided in the small claims jurisdiction it will therefore have no precedential value. Despite this it will be interesting to see whether the arguments canvassed in this case will be raised 'afresh' at some later date in a future case and also whether both the IRD and taxpayers refer to it while not necessarily 'applying it' as precedent or follow it. In this regard it is worth noting that an earlier decision of the TRA, case *No 18/01; Decision 8/2001*, heard in the small claims jurisdiction, is referred to in commentary on an aspect of the income tax legislation.¹²⁵ The author is also aware of one international Chartered Accountancy firm who, in a publication discussing *Case X26*, do not mention that it originated in the small claims jurisdiction and therefore is non-precedential, rather implicitly the case is represented as having authority (albeit lesser given its TRA status).¹²⁶

4.2.2 The relevant principles

At the start of his judgment Barber J acknowledged the factors developed by the courts to determine whether expenditure is on capital or revenue account but that resort to those factors is not necessary if the expense is, on its face, clearly either capital or revenue in nature.¹²⁷ It is only in borderline cases that the tests developed by the court should be used.¹²⁸ Barber J summarised the applicable approach as:¹²⁹

¹²¹ This is confirmed by the definition of "precedent" in Regulation 18(6) which defines the term to mean: "... a decision of the Authority that affects or may affect the outcome of a separate and unrelated dispute between the Commissioner and a taxpayer other than the disputant." This definition was introduced into the Regulations in 2004 and applies to disputes that are commenced under the disputes procedures on or after 1 April 2005.

¹²² Section 138N(2), Taxation Authorities Act 1994 (TAA 1994).

¹²³ Section 138O(2), TAA 1994.

¹²⁴ For example, where the CIR considers there are "significant legal issues of precedent" involved: s 138O(1), TAA 1994.

¹²⁵ See C.E. Bibbey, Section CH 2 "Benefit from share option or purchase schemes", *Brookers Smart Tax Commentary*, paras 2.2 and 2.3. The author of the Commentary finds some support from this case for her views concerning an aspect of the operation of s CH 2 of the Income Tax Act 1994.

¹²⁶ PricewaterhouseCoopers, "Repairs and maintenance" (2006) Issue 19 *Tax tips* (5 October) 1.

¹²⁷ For support for this position see for example *Milburn* where Wild J observed: "*BP [Australia]* considers a number of tests which assist in drawing the capital/ revenue distinction. As the Privy Council recognised in *BP*, resort to those tests is unnecessary in clear cases." (n 41, at 17,021)

¹²⁸ In his judgment Barber J (see n 110, at 12,318-12,319) specifically referred to passages of Dixon J in *Sun Newspapers* [1938] 61 CLR 337, and the *Hallstroms* test, noting that it had found favour with the courts including in the Privy Council in *BP Australia* and *CIR v Wattie* as well as the

“An appreciation of the totality of the expenditure (*Colonial Motor Co Ltd*) from a practical and business point of view (*Hallstroms*, *BP Australia*, and *Borthwick*) will normally be determinative of the nature of an expense.”

While this approach is that accepted by the New Zealand courts with respect to the capital-revenue distinction generally, the New Zealand courts have in the past adopted a slightly different approach to repairs and maintenance cases, such as *Case X26*. The approach is illustrated by the Court of Appeal and Privy Council in *Auckland Gas* where the courts used the following three-fold analysis:

- (a) the first step is to identify the object to which the test of repair or replacement is being applied;¹³⁰
- (b) the effect of the work on the character of the object is an important consideration. The main issue here is whether the character of the object has changed as a result of the expenditure;
- (c) there is no rigid test or description that can be applied and the answer depends upon a consideration of all the circumstances.

While his Honour did not specifically refer to this approach in his decision, implicitly Barber J has used it; determining the asset (the building) had been changed from one under risk of demolition to one that will continue to generate income.

4.2.3 Expenditure on Capital Account

Barber J at the outset of his decision concluded that the expenditure was clearly on capital account. It was to bring into existence advantages of a lasting nature which improved an identifiable asset, ie the building, as part of the partnership's income earning structure (as distinct from its income earning process).

Applying the *Hallstrom's* test, his Honour stated from a practical and business point of view that the project was intended to make a major alteration to the structural integrity of the property so it would meet statutory requirements and to avoid the possibility that the building would become a useless asset (due to the intervention of the Council):¹³¹

“Prior to the project the building, according to the disputant's own engineer: ‘has a capacity less than 50% of the 1965 code ... and that the building may collapse in a moderate earthquake ...’. The project was ‘to achieve full compliance with Chapter 8 of NZ1900:1965 in terms of applied loadings.’ At

Court of Appeal which had adopted it as exemplifying the “governing approach” in New Zealand: *Borthwick*, see n 13, at 9,103.

¹²⁹ See n 110, at 12,326.

¹³⁰ For this part of the inquiry it is crucial that the subject matter is correctly identified: see for example *Auckland Trotting Club v CIR* [1968] NZLR 967 and *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001, at 15,006. Misidentification of the asset in question could lead to distorted results if too large or too small a subject matter were identified.

¹³¹ See n 110, at 12,320.

the end of the project the engineers were able to certify that the seismic strengthening was completed. Accordingly, the project did not merely maintain or repair the property but substantially improved it: going from less than 50% earthquake strength compliance to full compliance. The end result was a substantially improved property.” (emphasis in original)

Barber J observed that the case *Colonial Motor Co Ltd v CIR*¹³² (*Colonial Motors*) was directly on the point of the tax treatment of earthquake strengthening costs. In that case, an unsound warehouse under threat of demolition because of earthquake risk was strengthened and transformed:¹³³ “into a sound commercial building with a substantial revenue earning life.”

There is a key difference between the cases - in *Colonial Motors* the work undertaken by the taxpayer went further than that in *Case X26*. In particular in the former case the taxpayer gutted the interior of each floor, enclosed the light well, erected a new glass curtain wall on one side of the building, removed a mezzanine floor, transferred all building services to a new central core location, completed seismic strengthening work, *added a ninth floor penthouse and refurbished the interior throughout so as to provide good quality modern non-air conditioned office space*. The strengthening consisted of the construction of two reinforced concrete shear walls from ground to sixth floor and the installation of diagonal steel bracing on the seventh and eighth floors. The work in *Case X26* did not go so far, being limited to earthquake strengthening work and in the author’s view is closer to the borderline between capital and revenue expenditure than the *Colonial Motors* case.

His Honour recognised the differences between these two cases, commenting:¹³⁴

“Of course, in the present case the work undertaken was not as extensive as that in *Colonial Motor Co Ltd v CIR*, but the same result must follow. There was work undertaken to improve the building’s earning-capacity by making it earthquake code compliant and thus avoiding the sterilisation of the asset. While the work in this case was to make the building earthquake-code compliant, it ensured the continued availability of the asset as part of the income-earning structure of the taxpayer’s partnership. That *structure* is a concept of capital. The *process* of earning income is revenue in concept.” (emphasis in original)

The unanswered question is, in the event that a taxpayer is required to do work on their property to keep compliant with the property code, is there a level of work which would be deductible? Where is the line between such deductible and non-deductible work? In determining the divide one potentially relevant case is *Conn v Robins Bros Ltd*¹³⁵ (*Conn*) where, despite the substantial work undertaken on the building (including structural work), the expenditure was on revenue account. The taxpayer in *Case X26* did not argue *Conn* in support of its position. In *Conn* extensive alterations were made to a 400 year old building including replacement of a slate roof with

¹³² (1994) 16 NZTC 11,361(CA).

¹³³ *Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,060, at 11,062 (HC).

¹³⁴ See n 110, at 12,323.

¹³⁵ [1966] 43 TC 266.

corrugated asbestos, removal of walls, insertion of steel girders to support the upper storeys, removal of rotten floorboards and the floor reformed in concrete.

Clearly where structural work is undertaken there is a greater likelihood that the work will go beyond repairs. However, that does not mean that all structural work will be on capital account. *Conn* is support for that proposition. In fact, in that case Buckley J commented that:¹³⁶ "... the fact that there were alterations in the structural details of the building does not seem to me to be a good ground for proceeding upon the basis that the work produced something new."

Barber J in *Case X26* observed that:¹³⁷ "Most building repairs involve work on, or even replacement of, building fabric in order to renew it. In the present case, the building work was to add to the existing structure in order to assist retain it as a structure."

In considering the character of the expenditure his Honour referred to a valuation report which showed that the total cost of the strengthening work was approximately 9.9 percent of the valuation of the property (or 10.5 percent adopting other figures). Barber J indicated it was appropriate to use the total cost of the project rather than merely the cost to the partnership as the latter measure would give a distorted and inaccurate reflection of the scope of the project. The cost to the partnership could not alter the amount the remedial work actually cost.

While the cost of such work may provide an indication as to the extent of the work (and therefore the nature and character of the expenditure), this measure should be used with caution. It is conceivable that the cost of work could, as a percentage of the asset value, be exceedingly high and still of a repair nature, and conversely capital expenditure a low percentage of the asset value (perhaps through the use of new technology) but still capital based on its effect on the object. Ultimately it is the effect the expenditure has on the asset that is important, for example has it simply repaired the asset or is it a major alteration.

His Honour accepted the evidence of the CIR's expert that the work did increase the capital value of the building. Barber J also noted that there would be an immediate threat of loss of the income from the property, as an income-earning structure, if it were to be barricaded by the Council. This could result in a loss in value of the property.

In the author's view, as with measuring the cost of the work against the asset's value, the impact on the value of the asset should be treated with caution. Unlike the ITA 1976 which contained a specific section allowing deductions for repair and maintenance (including a reference to the impact of the work on the asset's value) the ITA 1994 and ITA 2004 do not contain a separate provision. Arguably an asset in need of repair may increase in value after the repair work. A van requiring a new exhaust system may have a lower value prior to the replacement of the system. Depending on the replacement, especially if a longer life exhaust system is installed than previously existed, the repair may even increase the value of the asset to a figure

¹³⁶ Ibid, at 275.

¹³⁷ See n 110, at 12,326-12,327.

greater than prior to when the repair work was required. The key issue is the nature of the work based upon a practical and business point of view not its effect on the value of the asset. In this example the repair with a longer lasting component will still be deductible (despite its impact on the assets value) because it will not change the van. Barber J did acknowledge the potential limits of focussing on the impact of the work on the value of the asset stating:¹³⁸ “[t]he valuation issue is but one indicator of the nature of the expense...”

4.2.4 Deferred Repairs and Maintenance

The taxpayer submitted that the costs were incurred undertaking deferred repairs and maintenance which were no more than accumulated repair and thus of a revenue nature. Two cases were discussed by his Honour in response. In the first, *Odeon Associated Theatres v Jones*,¹³⁹ the taxpayer acquired some rundown theatres which had not been maintained due to wartime restrictions. Deferred maintenance was undertaken (including replacement carpets and redecoration) and this was considered to be on revenue account. The distinguishing factor in this case according to Barber J was that wartime restrictions prevented normal repair and maintenance from occurring and requiring a single “catch-up” effort once those restrictions were lifted. No such restrictions existed in the present case.

In addition (and in the author’s view more significantly) the effect of the strengthening, in the present case, was not merely to maintain the building, but to dramatically improve its structure. Had the work not been done, the building could have been barricaded and therefore it would have been rendered worthless as part of an income-earning structure. This provided a strong indication that the work was to protect a part of the income earning structure and was therefore on capital account. However, his Honour did acknowledge that:¹⁴⁰ “there could be a situation where a building was threatened with closure due to lack of repairs and maintenance. That threat would not convert the cost of remedial work into capital expenditure.”

The second case referred to was *Sherlaw v CIR*¹⁴¹ where the owner of a boatshed sought to repair the slipway, floor and piles of boatshed. Having commenced this, the re-piling became a much larger undertaking than anticipated (including the replacement of a substantial part of the roof), and it was decided to do other deferred maintenance. All this work was held to be on revenue account. The decisive factor in *Sherlaw* was that taxpayer had proceeded in an *ad hoc* manner. Barber J in *Case X26* quoted Doogue J in *Sherlaw*:¹⁴²

“In this case [*Sherlaw*] once the essential work was commenced other work became necessary... This is not a case, however, of the kind referred to me where there was one overall construction project resulting in the complete reconstruction of the boat-shed or of a project for the deliberate improvement of the boat-shed. Here the taxpayer chose to repair the boat-shed and, as a

¹³⁸ See n 110, at 13,323.

¹³⁹ [1972] All ER 681.

¹⁴⁰ See n 110, at 12,320.

¹⁴¹ (1994) 16 NZTC 11,290 (HC).

¹⁴² Ibid, at 11,294.

result of that decision, he was faced with consequential repair work and upgrading becoming necessary.”

Barber J contrasted *Sherlaw* with *Colonial Motors* on the basis that in the latter case the work was done as a consequence of a single plan. In *Colonial Motors* the Court of Appeal commented:¹⁴³ “If there was one overall construction project, it is the total work involved in relation to the particular premises which has to constitute ‘repairs or alterations of any such asset’”. In that case their Honours’ also observed that the total work:¹⁴⁴ “... was not and could not sensibly have been the subject of two independent unrelated contractual projects, one for strengthening the building and the other for new and repair work.”

His Honour distinguished the present case from *Sherlaw* as there was a carefully delineated scope of work done for the taxpayer and only the work necessary to strengthen the building was implemented. The partnership was not required to undertake other work in the course of the strengthening.

Barber J rejected the argument that because the partnership and previous owners had deferred doing the earthquake strengthening until required to by the Council this meant that when it was actually undertaken the work had the character of deferred repairs. Rather his Honour commented that deferred capital improvements remain capital improvements when actually completed, whether implemented soon or late.

How can cases such as *Colonial Motors* and *Case X26* be reconciled with cases such as *Conn* and *Sherlaw*, cases which all concerned substantial work on the building concerned? The answer lies in the second step referred to in the three-fold analysis in section 4.2.2 of this paper (the effect of the work on the character of the object) and is best expressed by Doogue J in *Sherlaw* contrasting the facts in that case with *Colonial Motors*:¹⁴⁵

“[*Sherlaw*] is far removed from the transformation of an unsound warehouse into a sound commercial building [*Colonial Motors*] with a substantial revenue-earning life. In this case the boat-shed remains a boat-shed of much the same lay-out and of the same size as previously.”

The building in *Colonial Motors* changed significantly (including the addition of a penthouse). Similarly the building in *Case X26* also had significant work undertaken on it changing it from an unsound to a sound building. His Honour described the work in that case as follows:¹⁴⁶

“In any case, the work now in issue simply was not maintenance work in character but was additional construction work to the corpus of the building somewhat similar to adding floors or extending the building structure. In effect, the building was semi-caged in steel as an addition to the previous structure. That could not be repairing or maintaining work.”

¹⁴³ See n 132, at 11,366.

¹⁴⁴ Ibid.

¹⁴⁵ See n 141, at 11,294.

¹⁴⁶ See n 110, at 12,322.

The buildings in *Sherlaw* and *Conn* by comparison remained the same size and layout, “the work no more than maintained the building’s inherent utility.”¹⁴⁷

4.2.5 Additional observations

4.2.5.1 Increased revenue

The taxpayer argued that the expenditure did not result in any increase in the rentals the building was capable of generating (upon annual reviews), which showed that the expenditure did not improve the building. Barber J responded that the expenditure was necessary to maintain the existing revenue stream and that, citing *Highland Railway Co v Balderston (Surveyor of Taxes) (Highland Railways)*,¹⁴⁸ “an increase in revenue is not a necessary concurrent result of a capital expense which improves a capital asset.”¹⁴⁹

4.2.5.2 Compliance with Statutory Requirements

Barber J commented that while the fact that the building required strengthening after the partnership was put on notice by the Council was a relevant factor it did not make the expenditure a revenue item. “The need to comply with statutory or regulatory requirements does not necessarily make the expense one of revenue. The issue is always the character of the particular expenditure.”¹⁵⁰

His Honour also observed that the fact that in the future the regulatory authority may require further work to be undertaken on the building did not mean that the current work lacked an enduring benefit. In this context an enduring benefit is not one that will last forever.¹⁵¹

“When the words ‘permanent’ or ‘enduring’ are used in this connection it is not meant that the advantage which will be obtained will last forever.”: *Sun Newspapers Ltd and Associated Newspapers Ltd v FC of T* (1938) 61 CLR 337, at p 355 per Latham CJ.”

4.2.5.3 “Cosmetic” alterations

The taxpayer submitted that some of the alterations were of a “cosmetic” nature. His Honour acknowledged that if this was the case that amount might be deductible as revenue depending on the precise character of that work. There was no evidence to that effect before his Honour but he did reserve leave to the taxpayer to apply in that respect.

¹⁴⁷ IRD, “Repairs and maintenance” (1994) *IRD Tax Information Bulletin* (February), 9 commenting on *Conn*.

¹⁴⁸ (1889) 2 TC 485.

¹⁴⁹ See n 110, at 12,323. In *Highland Railways* case the taxpayer incurred the expense of replacing steel rails with iron ones without earning any extra revenue as a result. The expenditure was considered on capital account because the asset had been materially altered and improved.

¹⁵⁰ *Ibid*.

¹⁵¹ *Ibid*, at 12,324.

4.2.5.4 Staggered alterations

The taxpayer submitted that she could have spread the work out over a period of years and charged it to repairs but, for the sake of the tenants of the buildings, decided to complete the strengthening project as a whole. Barber J commented that he could only deal with facts as they are but had the taxpayer so proceeded, the character of the expenditure year by year would still have been of a capital nature.

Such an approach is in agreement with other cases, including *Auckland Gas*¹⁵² where Lord Nicholls in the Privy Council stated that the fact that the replacement work in that case was spread over a number of years did not change the Board's finding (that the expenditure was of a capital nature.) His Lordship commented that "The speed or slowness with which the work was carried out cannot affect its nature or, hence, its proper characterisation."¹⁵³ Accordingly, where there is a programme to do work on an asset, simply by staggering or spreading repair or replacement work over a number of years will not change the character of that expenditure (from capital to revenue for example).

5.0 DISCUSSION AND CONCLUSION

Discerning the capital-revenue boundary can be difficult, hence the large volume of case law. For the purposes of this paper, the key issue is whether this case law has meant that over time making the distinction is simpler and less complex than it previously was. At one level, that of the relevant principles to be applied, the answer must be a clear "yes". Trombitas, in his survey of New Zealand cases on the distinction observes that:¹⁵⁴

"What is quite interesting is that the capital/revenue principles were very well developed by the 1930s [in New Zealand]. Courts in more modern times have been 'maintaining' the established principles and there appear to be no new capital/revenue tests emerging in New Zealand. The same cannot be said for Australia and Canada. All of the traditional tests are still being applied today, but the test that is being questioned the most is the fixed/circulating capital test."

Templeman J's comments in *Tucker*¹⁵⁵ that the capital-revenue distinction is "an intellectual minefield in which the principles are elusive", at least in the New Zealand context, are no longer applicable.

The two cases discussed in this paper illustrate the principled approach adopted by the New Zealand courts to determining capital-revenue issues (and referred to by Trombitas). In particular, the courts in *Fuller* and *Case X26* acknowledge:

¹⁵² *Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702.

¹⁵³ *Ibid*, at 15,708.

¹⁵⁴ E Trombitas, "The New Zealand Judiciary and the Capital/Revenue Distinction at the Beginning of the Twenty-First Century" (2006) In Adrian J Sawyer (Ed.) *Taxation Issues in the Twenty-First Century* (Christchurch: The Centre for Commercial and Corporate Law Inc.) 79, at 94.

¹⁵⁵ See n 6, at 869.

- (a) the need to determine what the expenditure was calculated to effect from a practical and business perspective (the *Hallstroms* test);
- (b) related to (a), the need to make a “precise analysis of the relevant facts of each case”¹⁵⁶ and examination of the authorities on point. What may appear to be relatively small and insignificant factual differences between cases can alter the determination of the character of the expenditure in question;
- (c) the application of the tests established in *BP Australia*. Not all of these tests may be applicable in a particular case. Two tests, the ordinary principles of commercial accounting and fixed and circulating capital tests clearly are of less relevance; indeed the continuing relevance of the latter test has recently been questioned in *Fullers* (HC) (and *Milburn*). On the basis of (a) and (b) where it is clear that the expenditure under scrutiny is revenue or capital resort to these tests is unnecessary, but may confirm the determination made.¹⁵⁷

Trombitas correctly concludes that:¹⁵⁸

“Having analysed the modern [New Zealand] cases, as well as the historical approach of the courts, it may not come as a great surprise to a number of the readers that my overall impression can be summed up as follows: ‘*There is nothing new under the sun in the capital/revenue area.*’ This is really saying that the courts adopt a very conventional and principled approach in dealing with capital/revenue issues – in this sense there is nothing new. There is no new approach and there is certainly no magic formula. Of course, statutory modifications have been made and will continue to be made.” (emphasis in original)

However, this is not the complete story. Due to the fact that the capital-revenue issue is ultimately a factual one, as the two cases in this paper illustrate, there will always be scenarios coming before tax advisers and the courts with subtle (and not so subtle) factual differences from decided authorities. This creates complexity and uncertainty. For example, with respect to strengthening work on a building, is there a level of work which is deductible as repairs and maintenance, and if so, where is that level? Similarly, had the potential impact of the contract in *Fullers* been to increase their revenue by 10% or 20% would the result have been different?

In addition, from time to time there will arise scenarios where there is no direct authority – the tax treatment of lease incentives in New Zealand, prior to *Wattie*,¹⁵⁹ was such an example. In these cases, the settled principles established and followed by the New Zealand courts will assist in determining the character of the expenditure. However, ultimately a careful analysis of the particular facts and legal arrangements will be crucial to coming to the correct answer.

¹⁵⁶ See n 20, at 18,841. In the context of repairs and maintenance expenditure, as noted, the New Zealand courts usually adopt a three-fold analysis including (i) identifying the asset and (ii) examine the effect of the work on the asset.

¹⁵⁷ See also Wild J in *Milburn*, n 41, at 17,025.

¹⁵⁸ See n 154, at 93-94.

¹⁵⁹ See n 13.

This paper has focussed on the approach of the New Zealand courts to the capital-revenue distinction, as evident in two recent cases. Two extensions of this paper could be made. The first, to compare the approach of the New Zealand and Australian courts to making the capital-revenue distinction. The second extension could be to compare the findings of the courts in these two cases with overseas cases with similar factual scenarios.